MEMORANDUM

Montana Board of Investments
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To: Legislative Finance Committee

From: Carroll South, Executive Director

Date: December 11, 2007

Subject: Short Term Investment Pool (STIP) Investments/Withdrawals

HISTORY – The STIP was created by the Legislature on July 1, 1973 as an investment vehicle to manage state and local government cash. State agencies utilize STIP for accounts that are entitled to retain their interest earnings and have no other options for the investment of their cash. Local governments have other options as permitted by law and use STIP at their discretion.

The STIP investments on June 30, 2007 totaled $2.8 billion with 479 individual accounts participating throughout the fiscal year, including 193 local government accounts. Since its creation the STIP has provided a convenient way for state and local government agencies to invest and withdraw cash with 24-hours notice. The pool distributed $125 million in income to state and local government agencies for Fiscal Year 2007.

Local Government Participation – The law creating STIP and permitting local governments to participate was one of 10 sections contained in legislation to enact the unified investment program required by the new Constitution. There is no "statement of intent" to determine the original legislative intent of the following provision of the law.

> **"17-6-204(3) The principal and accrued income, and any part thereof, of each and every account maintained for a participant in the pooled investment fund shall be subject to payment at any time from the fund upon request. Accumulated income shall be remitted to each participant at least annually."**

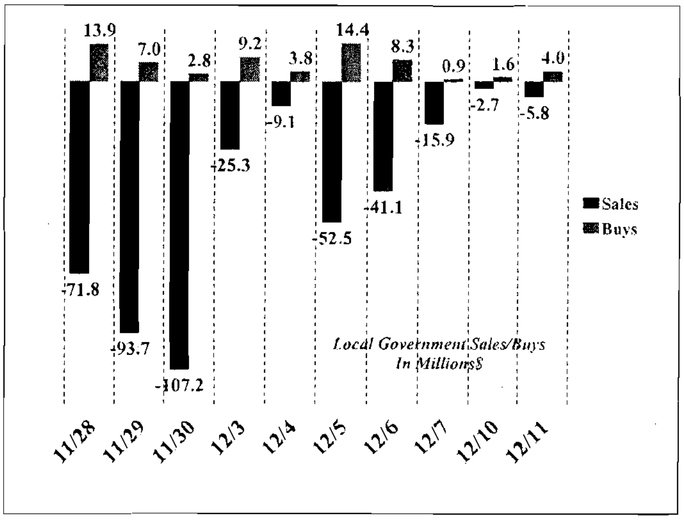
This language seems to provide an implicit guarantee of local government principal held in the STIP. The Board's legal counsel believes that "principal" in this context means that local governments are entitled to receive their full principal upon request. This provision prevents the Board from taking any action to mitigate the impacts that significant local government fund withdrawals may have on state agencies and local government that remain in the pool.

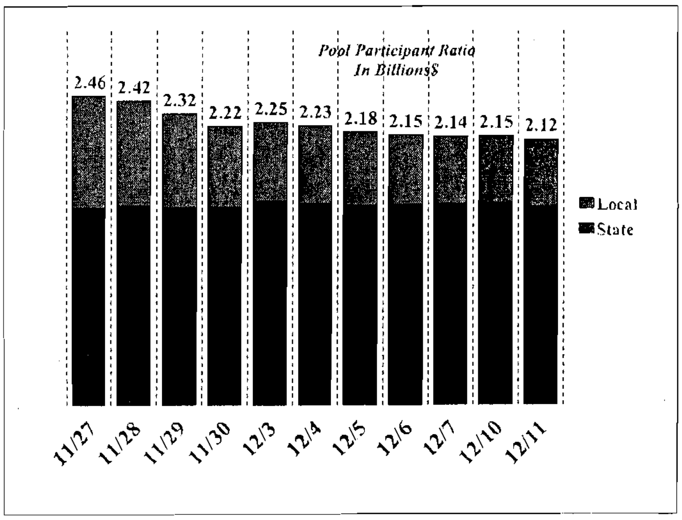
While the law permits local government to invest in the STIP at their discretion, it appears that the Board has no discretion as to whether it accepts and manages local government funds. This section of the law states:

> **17-6-204. Investment of local government funds. (1) The governing body of any city, county, school district, or other local government unit or political subdivision having funds which are available for investment and are not required by law or by any covenant or agreement with bondholders or others to be segregated and invested in a different manner may direct its treasurer to remit such funds to the state treasurer for investment under the direction of the board of investments as part of the pooled investment fund.**

The net effect of these provisions is that the Board has no control over the deposits or withdrawals of local government funds in the STIP, which on November 27, 2007 comprised 36.4 percent of the pool.

LOCAL GOVERNMENT WITHDRAWALS – Within the past two weeks local governments have withdrawn significant amounts from the STIP. The adjacent chart shows local government sales and purchases beginning November 28 through December 11. Total withdrawals during the period were $425.0 million. Total purchases were $66.0 million for a net reduction in local government funds of $359.0 million. The local government balance of $896.2 million before the withdrawals began was reduced by 40.0 percent during the period. The Board has never before encountered such a substantial withdrawal of local government funds in such a short period of time. While these withdrawals have been accommodated without a forced liquidation of securities in the pool, the magnitude of the withdrawals and the resulting media coverage have been rather disconcerting to those local governments that chose to remain invested in the STIP.





The overall size of the STIP has decreased from $2.5 billion to $2.1 billion during the period. Due to the reduction in local government funds, the state agency portion of the STIP has increased. Although the absolute dollar amount of state agency funds changed little during the period, the portion of the pool comprised of state funds increased from 64.0 percent to 75.0 percent. The stability of the state funds anchor has mitigated much of the impact of large and sudden local government withdrawals. Additionally, in August the Board began shortening the STIP duration and increasing liquidity to ensure that sufficient funds were available to fund increased withdrawals without having to liquidate securities in the pool.

While the Board has been able to handle the surge of withdrawals without negatively impacting state and local agencies that remain in STIP, it has resulted in a rather difficult environment. On November 29, while executing the Automated Clearing House system to transfer the withdrawals for the next day to local government banks, the system bumped up against the $99.9 million daily limit set by the US Bank per each satellite. The remainder of the $107.0 million in withdrawals had to be sent the following day. Board staff has also fielded numerous calls and e-mails from concerned local government participants that are concerned about the impact these large withdrawals may have on their funds if they remain in the pool. Unlike state agencies funds whose large inflows and outflows we can monitor closely, staff is not able to predict the amount or timing of large local government withdrawals but must make their funds available on one day's notice. This has been rather disruptive to the planning and management of the underlying STIP investment portfolio.

Additionally, the withdrawals and the subsequent media coverage have resulted in many inquiries from local governments as to whether they should continue to invest in the STIP when some of their peers are withdrawing their funds. This places staff in an awkward position because the Board is not a financial advisor and cannot recommend or advise investment options to local governments. It is the local government officials with the fiduciary responsibility for the funds who should weigh the risk and return of the STIP to other available investment options and make the investment decision. The Board has never actively promoted STIP to local government officials but simply made them aware that it is an investment option available to them.

THE STIP INVESTMENT PORTFOLIO

Sub-prime Mortgages - There has been much media discussion recently of the "sub-prime" mortgage crisis and its impact on both private and public money market type funds. The implication is that funds such as the STIP have large holdings of "sub-prime" mortgages that are failing. While the sub-prime problem may have precipitated a much larger global credit problem, sub-prime mortgage exposure has little impact on the STIP portfolio. The portfolio holds no direct sub-prime mortgages and of the total assets backing structured investments, only $19.54 million is comprised of securitized sub-prime mortgages, or less than 1.0 percent of the pool.

Structured Investment Vehicles – These investments, usually called SIV's, are now one of the hottest subjects in the financial media. Until a few months ago most people outside financial circles had probably never heard the phrase. The first SIVs were founded in the mid-1980s as bankruptcy-remote entities and were sponsored by large banks or investment managers for the purpose of generating leveraged returns. They do this by earning the spread (differences in yields) between the longer-dated assets purchased and the short-term liabilities issued. The balance sheet of a structured investment vehicle typically contains assets such as asset-backed securities (ABS) and other high-grade securities.

Maintaining a high quality asset portfolio is a fundamental part of running a SIV. The purchase of these assets is funded through issued liabilities in the form of commercial paper (CP), medium-term notes (MTNs) and subordinate capital notes. The CP and MTN are given the highest credit ratings (A1/P1 or AAA) from one or more of the three major rating agencies. However, in order to maintain the AAA-rating, SIVs have to demonstrate compliance to a stringent set of operating guidelines that cover a wide range of performance characteristics including projected cash-flows, diversification risks, market rate sensitivity and capital adequacy. These tests are conducted on a very frequent basis; some may be required daily.

The Board currently holds $525.0 million of SIV's in the STIP portfolio. The list below shows the date they were purchased, the investment rating at the time of purchase, the broker, the sponsor, and the maturity date.

Date	Issue	Moodys	S&P	Par	Maturity	Broker	Sponsor
12/11/06	Cullinan Finance	Aaa	AAA	25,000,000	01/04/08	HSBC	HSBC
12/22/06	Premier Asset	Aaa	AAA	30,000,000	12/21/07	Merrill	Societe Generale
01/12/07	Theta	Aaa	AAA	15,000,000	01/14/08	JP Morgan	Theta
02/08/07	Theta	Aaa	AAA	40,000,000	02/08/08	JP Morgan	Theta
01/16/07	Orion	Aaa	AAA	25,000,000	01/16/08	Merrill	Orion
04/20/07	Orion	Aaa	AAA	25,000,000	04/21/08	Merrill	Orion
01/30/07	Sigma	Aaa	AAA	30,000,000	02/04/08	Lehmans	Sigma
02/28/07	Parkland	Aaa	AAA	25,000,000	02/28/08	JP Morgan	Bank of Montreal
05/25/07	Parkland	Aaa	AAA	25,000,000	05/27/08	JP Morgan	Bank of Montreal
03/13/07	Courtland	Aaa	AAA	50,000,000	03/13/08	Merrill	Ontario Teacher's Pension
04/30/07	Courtland	Aaa	AAA	25,000,000	04/15/08	Merrill	Ontario Teacher's Pension
04/12/07	Axon	Aaa	AAA	40,000,000	04/14/08	Merrill	Axon
04/16/07	Axon	Aaa	AAA	50,000,000	04/15/08	Merrill	Axon
05/29/07	Harrier	Aaa	AAA	40,000,000	05/29/08	JP Morgan	WestLB
06/06/07	Harrier	Aaa	AAA	40,000,000	06/06/08	JP Morgan	WestLB
06/20/07	Vetra	Aaa	AAA	40,000,000	06/20/08	Lehmans	Citibank
	Total			**525,000,000**			

The initial ratings of these investments were the highest rating possible and are identical to the ratings for bonds issued by the United States Government. The two rating agencies providing initial ratings for these investments continue to track them closely through the turmoil in the debt markets. The agencies rate not only the investment itself but the assets backing the investments.

S&P Ratings - The Axon investment was downgraded to "D" on November 27 due to the triggering of an "automatic liquidation event." The investment is currently being restructured by a committee of senior creditors owning more than 80.0 percent of the total $8.3 billion issue. All the underlying assets backing the investment are still in place. The Board, as one of the senior creditors, is monitoring the progress of the restructuring.

On December 7, the agency updated the ratings on the following investments:

Investment	From	To
Harrier	AAA	AAA/Credit Watch Negative
Orion	AAA	AAA/Credit Watch Negative
Premier Asset	AAA	AAA/Credit Watch Negative

These investments still maintain their AAA rating but were placed on credit watch negative while the agency continues to monitor the ratio of underlying asset values backing the investments, any restructuring that may be occurring, and the identification of liquidity providers. The asset/liability ratio is totally driven by the "mark to market" requirement of the underlying assets. Each investment may have a different ratio requirement and when the ratio is breached due to underlying assets being marked down, an "enforcement" action of some type may occur. These investments have an independent Trustee that holds the underlying assets while the investment manager makes day to day investment decisions. An enforcement action may require that the Trustee assume total control of all assets, essentially removing investment decisions from the manager.

Moody's Ratings - On November 30, the agency updated the ratings on the following investments:

Investment	**From**	**To**
Harrier	Aaa	Aa1
Orion	Aaa	Baa3
Axon	Aaa	Ba3

When issuing these updates, the agency noted that the actions taken today, "are not a result of any credit problems in the assets held by the SIV's, but rather a reflection of the continued deterioration in market value of SIV portfolios combined with the sector's inability to refinance maturing liabilities."

The agency was to have updated ratings again on December 7 but instead delayed the updates for two weeks. The agency states that some SIV managers are implementing restructuring proposals that should offer more protection to senior debt holders and are attempting to avoid unwinding the structures while the underlying assets are under price pressure. These activities will be considered when it next issues ratings updates.

Type of Assets Backing the SIV's – The 525.0 million in SIV investments are backed by these underlying assets.

Asset Type	Amount	Asset Type	Amount
Financial Institution Debt	$ 228,644	Student Loans	10,254
Prime Residential Mortgages	101,150	Sovereign Debt	5,242
CDO/CLO/CBO *	67,143	Auto/Plant/Equipment Loan/Lease	3,552
Commercial Mortgages	52,820	Other Loan/Lease	2,056
Credit Card Receivables	23,338	Corporate Debt	464
Sub-Prime Residential Mortgages	19,541	Consumer Loans	195
Other	10,446	Agency Debt	156
		Total in Millions	**$ 525,000**

* Collatoralized Debt Obligations/Loan Obligations/Bond/Bank Obligations

All of the underlying assets continue to have "investment grade" ratings as shown on the following page.

Investment		AAA		AA		A		BBB		Total
Axon Financial	$	87,120	$	2,610	$	270	$	-	$	90,000
Cortland Capital		44,325		25,425		5,250		-		75,000
Cullinan Finance		19,675		4,700		475		150		25,000
Harrier Finance		51,680		21,680		6,640				80,000
Orion Finance		24,655		24,820		525		-		50,000
Parkland Finance		24,250		23,700		1,950		100		50,000
Premier Asset		22,446		4,050		2,499		1,005		30,000
Sigma Finance		15,720		11,640		2,250		390		30,000
Theta Corp		6,892		25,311		20,708		2,090		55,000
Vetra Finance		36,920		3,080		-		-		40,000
Total	**$**	**333,683**	**$**	**147,016**	**$**	**40,567**	**$**	**3,735**	**$**	**525,000**

IMPACT ON THE STIP PORTFOLIO

There has been no material impact on the assets in the STIP portfolio due to the SIV holdings. The STIP is operated as an "amortized cost" fund, which means that the individual securities in the portfolio are not priced daily but are held at "cost" until maturity. This accounting methodology assumes that investments are "purchased and held" to maturity rather than sold at a loss or gain prior to maturity. This methodology is required to maintain a constant share price. If securities were priced daily, there could be a different share value each day. All securities in STIP, including the SIV holdings are held at amortized cost.

There is currently underway a sponsor-led restructuring of several SIVs that are designed to avoid fire sales of the underlying assets. Harrier ($80.0 million), Cullinan ($25.0 million), and Premier ($30.0 million) now have a direct line of support from their sponsors which effectively removes the triggers that could potentially lead to a fire sale of underlying assets. These investments are now de facto bank obligations which provide significant credit support beyond that derived from the underlying assets. On December 5th, a $25.0 million SIV was sold at par.